The Financial Crisis Ten Years On: Creditors' Protection in Insolvency Law

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Abstract

Nowadays, ten years on after the financial crisis, we are still, somehow, experiencing global financial shockwaves. Such financial instability, though not the same as before, affects the protection of the creditors; for, it has generated a sharp shift in public discourse and at the same time a wide regulatory interest, both in the U.S. federal bankruptcy system as well as in the laws of various jurisdictions in Europe whereby the debate continues on how to better address the needs of the present, on how to optimally design bankruptcy laws and finally on how to better shape the policies of the future. Resulting from the above are the various economic challenges facing both the U.S. and the E.U. especially in connection to creditors' protection. As governments worldwide tackle the issue of optimal restructure of corporate and insolvency law, we critically discuss the position in relation to the creditors' protection under the legal regimes of USA, Germany, Greece and Croatia.

I. Introduction

It is human nature to act in one's own interest. Though ethicists and psychologists may disagree about the extent to which self-interest is a motivating factor behind human behavior, most accept that it plays some role. Assuming that human behavior is at least in part a function of self-interest, laws should be expected to reflect that behavior. Many laws already do. However, where money is involved, the need to curb the incentive to advance one's own interests at the expense of another is even greater. For example, the law prohibits a corporate director from enriching himself at the expense of the corporation, and whilst other shareholders have a right to contest the decisions of the general assembly that foster the interest of the single shareholder - but do damage to the corporation in general, nevertheless, special representation of the corporation is required in case a director holds, at the same time the role of another counter party and so on. All these rules are actually mechanisms, that play a significant role in managing the conflict of interest that inevitably appears at some point in every corporation and should not be seen as a negative event *per se*. Rather, it is just one of the circumstances that require special rules for the sake of the successful management of the corporation.[1]

In the insolvency law, where many stakeholders, such as the debtor itself, creditors, employees, insolvency administration, are involved, conflict of interest can appear at every step of the way, and, therefore, it is very important to ensure a level playing field among all these participants, ensuring them adequate means for the protections of their own interests. Insolvency rules gain particular importance at the time of financial crisis, when usually the number of insolvent companies grows. These periods usually serve as cornerstones of new insolvency regimes, that are usually introduced due to the specific

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[1] C.D. Kandestin, *The Duty to Creditors in Near Insolvent Firms: Eliminating the "Near-Insolvency" Distinction*, 60 Vand. L. Rev. 1235, 1236.

circumstances that require new ways of problem solving. One of these "cornerstones" of "legal insolvency history" is definitely the financial crisis that struck the whole world economy more than ten years ago and started a "revolution" in the existing legal frameworks throughout the world. This "revolution" shook the insolvency regimes of almost all the countries which were experiencing the financial crisis and did not stop only in this legal area but, unavoidably, in many case, also continued and expanded into the area of execution and civil law as well.[2] A similar "revolution" in insolvency law happened also before World War I, when the number of insolvency procedures in France increased for 240%, resulting in the exclusion of minor debtors from the solvency procedure.[3]

In the modern era, though, not only the content of the insolvency law required significant changes, but, also, the scope of its application - in the geographical sense - called for significant changes, as well. The fact that the EU promulgated the unification of the European market and economy, together with the increase of related parties or corporations with international background, resulted in the fact that a need for a single unique rulebook for insolvency procedures started to appear, even before the financial crisis had hit many countries and had affected many legal regimes. Therefore, the fact that in 2000 the EU Regulation on Insolvency Proceedings (1346/2000) was enacted, together with other regulations or directives which continued to develop in the sphere of the insolvency law, is not something to wonder about. This trend was, however, "old news" in the USA, where already from 1789, via the Constitution, it was ensured that insolvency matters were to be regulated on the federal level.[4]

II. USA - The Purpose of Adequate Protection

In the USA, the concept of adequate protection derives from the Fifth Amendment protection of property interests. Adequate protection, however, is more than a constitutional protection of the creditor's interest in the property. Section 361 of the US Bankruptcy Code (USBC) and the concept of adequate protection, are generally based as much on policy grounds.

Section 361 USBC recognizes the availability of alternate means of protecting a secured creditor's interest. Though the creditor might not receive his bargain in kind, the purpose of the section is to ensure that the secured creditor receives in value essentially what he bargained for. The basic purpose of adequate protection is to replace the protections afforded to a secured creditor by a bankrupt debtor's continued possession of its collateral. Adequate protection payments are designed to compensate the holder of a secured claim for any decline in the value of its collateral, that occurs after the bankruptcy filing. There is no express statutory requirement that unsecured creditors be provided

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[2] D. Bodul; A. Vuković, *(Another) Bankruptcy Legislation reform - functionalization of bankruptcy legal protection or placebo effect? [(Još jedna) reforma stečajnog zakonodavstva – funkcionalizacija stečajno pravne zaštite ili placebo efekt?]*, Zbornik Pravnog fakulteta Sveučilišta u Rijeci, Vol. 36, No. 1, 2015, p. 183.

[3] Ž. Bartulović; D. Bodul; A. Vuković, *Legal history and comparative review of the development of bankruptcy proceeding [Pravnopovijesni i poredbenopravni prikaz razvoja stečajnog postupka],* Zbornik Pravnog fakulteta Sveučilišta u Rijeci, Vol. 34, No. 2, 2013, p. 920.

[4] Ž. Bartulović; D. Bodul; A. Vuković, *Legal history and comparative review of the development of bankruptcy proceeding [Pravnopovijesni i poredbenopravni prikaz razvoja stečajnog postupka],* Zbornik Pravnog fakulteta Sveučilišta u Rijeci, Vol. 34, No. 2, 2013, p. 928.

adequate protection. The Bankruptcy Code requires a debtor to provide adequate protection to a secured creditor in at least three circumstances: (1) when the secured creditor seeks to lift the automatic stay, and the court finds that there is a lack of adequate protection; (2) when the debtor uses, sells, or leases a secured creditor's collateral; and (3) when the debtor proposes to prime a secured creditor's lien, with an additional lien. In these instances, a secured creditor must request that the bankruptcy court order the debtor to provide adequate protection of the secured creditor's interest. While the stay provisions of section 362 USBC require that a secured creditor's interest be adequately protected, most courts still require that the secured creditor actually request the relief or adequate protection prior to the court ordering it. The bankruptcy court may condition the continuation of the automatic stay on the provision of adequate protection, but the lien creditor must first "request" relief from the stay. Similarly, secured creditors must request adequate protection when a debtor intends to use, sell, or lease the secured creditor's non-cash collateral. Courts will place the onus of requesting adequate protection on the secured creditor. The rules are different when the debtor wants to use cash secured by a lender's lien, as the debtor cannot use this cash collateral, unless it first provides the secured creditor with adequate protection. The debtor does not have the right to use cash collateral without either the consent of the secured creditor or an order of the court.[5]

a) Corporate Fiduciary Duties

In insolvency circumstances, secured creditors are entitled to protection of their interests in the debtor's property. Adequate protection is a creditor's right to receive compensation from a debtor for any decline in the value of its collateral during a bankruptcy case. Courts require the debtor to provide the secured creditor with adequate protection while the automatic stay is in effect, while the debtor is using a secured creditor's collateral, or when the debtor proposes to prime a secured creditor's lien on collateral and creditors must come to court prepared to present sufficient evidence to secure adequate protection of its interests.[6]

While the law of fiduciary duty is clear when applied to healthy, solvent corporations, its application becomes muddled when applied to financially distressed companies. In part, this is because a financially distressed company is a different beast than a solvent one. Whereas these interests are usually harmonious in a solvent corporation, each self-interested constituency might find itself in tension with the others when insolvency is looming. Consequently, as a corporation nears insolvency and finally becomes insolvent, the common law's emphasis on shareholder interests makes less and less sense. Upon insolvency, shareholders have nothing more to lose, as little equity remains in the company. At the same time, however, they still have everything to gain; although their shares are presently worthless, they retain the potential to be worth something, if the corporation can reverse its financial distress. A rationally self-interested

[5] B.D. Bensinger, T.M. Lupinacci, *Adequately protect your interests in an economic crisis: proactive steps for lenders facing bankrupt borrowers*, Business Law Today. 17.5.2018 (May-June 2008), 51; C.D. Kandestin, *The Duty to Creditors in Near Insolvent Firms: Eliminating the "Near-Insolvency" Distinction*, 60 Vand. L. Rev. 1235, 1241.

[6] B.D. Bensinger, T.M. Lupinacci, *Adequately protect your interests in an economic crisis: proactive steps for lenders facing bankrupt borrowers*, Business Law Today. 17.5.2018 (May-June 2008), 51.

shareholder would favor high risk ventures to maximize the company's value, since he cannot afford to lose any more money. The shareholder becomes a high stakes gambler, using "other people's money" – i.e. the creditors' money, as *ante*. Given the limited downside, why not gamble with the corporation's remaining assets and try to rebuild some of its value?

From the creditor's point of view, however, this is an undesirable course of action because shareholder risk-taking will, more likely than not, diminish the value of the remaining corporate assets from which the creditors must get paid. If the compnay is truly insolvent, then the creditors will satisfy their claims with money derived from the liquidation of corporate assets, with each creditor taking his share of the corporate pie. Any dissipation of these assets, caused by precarious ventures taken on behalf of the shareholders, will mean less money for the creditors. From the creditor's standpoint, insolvency causes the shareholder to lose his status as a residual claimant, since it is now the creditors who bear any risk of loss.

Although law as applied to near-insolvent firms is unclear, it is at least clear that upon insolvency in fact, a duty is owed to creditors. This duty arises from the "trust fund doctrine," which holds that the directors of an insolvent corporation become the trustees of the remaining corporate assets, of which the creditors are the beneficiaries. A fiduciary duty is owed to the creditors of a company that is insolvent in fact. It is still unsettled, however, whether this duty extends to creditors when a corporation is in a state of near-insolvency. State courts and federal bankruptcy courts have considered the issue of fiduciary duties in near-insolvent companies. At one end of the spectrum, courts allow for the possibility of an affirmative duty to creditors. At the other extreme, courts hold that no real "duty" is owed to creditors of near-insolvent companies.[7] It is supported that the idea that creditors are the beneficiaries of fiduciary duties in near-insolvency is not a valid one and that directors of near-insolvent companies need not consider creditor interests, for, their duty is really owed to the corporation itself.[8] Fiduciary duties are context-specific, for they shift to new beneficiaries as the financial status of the corporation changes.[9]

a) The Road from Solvency to Bankruptcy

The courts have defined four major financial conditions a company may experience as it deteriorates from solvency to bankruptcy.' In the first condition, the company is solvent where its current assets exceed its current liabilities. A solvent company should have cash reserves, annual surpluses, minimal levels of debt, and the ability to invest in its future operations. The second condition, that of the zone of insolvency, includes a financially distressed company with deteriorating fiscal conditions, such as minimal cash reserves, only marginal surpluses, increasing debt, and an inability to invest in future operations. In the third condition, that of insolvency, the worsening of

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[7] C.D. Kandestin, *The Duty to Creditors in Near Insolvent Firms: Eliminating the "Near-Insolvency" Distinction*, 60 Vand. L. Rev. 1235, 1237.

[8] C.D. Kandestin, *The Duty to Creditors in Near Insolvent Firms: Eliminating the "Near-Insolvency" Distinction*, 60 Vand. L. Rev. 1235, 1239; *Mills Acquisition Co. v. MacMillan, Inc.*, 559 A.2d 1261, 1282 n.29 (Del. 1989), *Paramount Commc'ns, Inc. v. Time, Inc.*, 571 A.2d 1140 (Del. 1990).

[9] C.D. Kandestin, *The Duty to Creditors in Near Insolvent Firms: Eliminating the "Near-Insolvency" Distinction*, 60 Vand. L. Rev. 1235, 1241; J.A.Pearce II, I.A. Lipin, *The Duties of Directors and Officers Within the Fuzzy Zone of Insolvency*, American Bankruptcy Institute Law Review, 2011, 361-399, 361.

the company's economic condition, causes the company to become insolvent, as determined by the Bankruptcy Code or by case law. In the fourth condition, that of bankruptcy, the company either voluntarily files for bankruptcy or is involuntarily pulled into bankruptcy by its creditors. To address standards applicable in a particular jurisdiction, counsels should examine the laws of the specific jurisdiction involved because questions of director and officer liability and other corporate affairs are determined under the laws of jurisdiction of incorporation.

The zone of insolvency and bankruptcy conditions are particularly litigious, because the potential financial losses during these periods are especially large. The 2007-2009 recession in the U.S. produced extremely high degrees of these two conditions. The lack of an unambiguous, legal, and operational definition permits creditors, shareholders, courts, and other parties to unreliably, unpredictably, and inconsistently classify companies as operating in the zone of insolvency. The problem posed by the zone of insolvency, needs to be addressed, in order to resolve uncertainty in the law, redefine fuzzy and ambiguous standards, specify the scope of the zone, and provide guidance to directors and officers.[10]

b) Zone of Insolvency

Zone of insolvency is a financial condition that exists for a company during an indeterminate period between its solvency and insolvency. A great obstacle for corporate investors and creditors - as to the understanding the duties they are owed by directors and officers - is created by the judicial finding that the zone of insolvency is less objectively determinable than insolvency. The zone of insolvency does not have a generally accepted definition and the judiciary provides only limited guidance as to its definitional scope. It has been suggested that a company is in the zone of insolvency if the company has "unreasonably small capital," which is "a condition of financial debility short of insolvency but which makes insolvency reasonably foreseeable."

In insolvency, the fiduciary duties of directors and officers extend to a company's creditors, even as the duties continue to be owed to the corporation. The courts are divided on the issue of whether directors' and officers' duties to shareholders completely terminate at corporate insolvency. Some courts adopt a view that when the corporation becomes insolvent, directors and officers no longer represent the shareholders, but the creditors. However, other courts have stated that the directors' and officers' duties extend to creditors and become primary, while the duties to shareholders remain, but become secondary in nature. The logic for this second position is that an insolvent corporation's shareholders are “last in line” for repayment and there is no repayment for the shareholders until the creditors have been paid.

There are five general tests, which are being used to determine if the company is insolvent: a) under the equity test, the company is considered insolvent when it is unable to pay its debts as they come due in the ordinary course of business. A company is insolvent in the equity sense if its assets lack short-term liquidity; b) under the balance sheet test, the company is insolvent when its assets are below its liabilities with no reasonable prospect that the business can successfully be continued; c) under the future

[10] J. Wood, *Director’s Duties and Creditor Protections in the Zone of Insolvency: A Comparison of the USA, Germany and Japan*, 26 Penn St. Int'l L. Rev. 139,139; C.D. Kandestin, *The Duty to Creditors in Near Insolvent Firms: Eliminating the “Near-Insolvency” Distinction*, 60 Vand. L. Rev. 1235, 1243.

operations test, the company's capital is evaluated in terms of its ability to support financing of its future operations; d) under the insolvency in fact test, a company is insolvent when it has liabilities in excess of the reasonable market value of assets held. This fourth test is considered to adopt a broad view of insolvency, under which almost any start-up company may be considered insolvent; e) under the bankruptcy test, a corporation is insolvent when its debts exceed the fair value of its property.[11] This variety of tests creates additional uncertainty for a court, since any test can potentially be used to determine if the company is insolvent, however, generally speaking, there are three tests to determine if a company is solvent, and courts usually employ either the balance sheet, or the cash flow, or the thin capital tests, in order to determine the company's solvency. The variety of tests and lack of definitional or pro-forma appropriateness of each test adds to the uncertainty of litigants, because parties know that the evaluation of the company's financial position is partially dependent on the specific test or tests a court chooses to employ.

The extension of a director's fiduciary duties to creditors is granted through a trust fund doctrine. Although the fiduciary duties of directors and officers extend to creditors when the company is in insolvency, the duties of loyalty and care remain the same and the rules of corporate governance continue to apply. In addition, courts have recognized supplemental fiduciary duties that directors and officers owe to creditors while the corporation is insolvent. The rationale for expanding fiduciary duties to creditors during the insolvency, is that creditors bear the brunt of damages for the conduct of directors and officers, as contrasted to shareholders who have theoretically lost their investment. The extension of fiduciary duty to creditors is also justified by the difference of investment risk between shareholders and creditors. The shareholders invest by buying stock, with hopes that the corporation will generate profit and increase the value of the shareholder's investment, while the creditors lend money to the corporation with hope that they will recover their money with interest. During insolvency, directors and officers must be concerned about another variant of the breach of fiduciary duties, known as the theory of deepening insolvency.[12]

c) *Bankruptcy*

A lot of legal systems have held as example the famous Chapter 11 USBC 1978, including the German Law on Bankruptcy of 1994 and the Greek Bankruptcy Code (GBC) of 2007. In the USA, the procedure under Chapter 11 USBC is not a pre-bankruptcy procedure, but actually a bankruptcy procedure *per se*, however not leading to liquidation but to the salvage of the company, through its reorganization.[13] As soon as the filing for the procedure under Chapter 11 USBC takes place, the company is protected from any claims from creditors as there is a guaranteed automatic stay[14] and the company has 120 days (possible to be extended by courts – if needed – to 18 months) to propose a

[11] J. Wood, *Director's Duties and Creditor Protections in the Zone of Insolvency: A Comparison of the USA, Germany and Japan*, 26 Penn St. Int'l L. Rev. 139, 151; C.Mallon, S.Waisman, *The Law and Practice of Restructuring in the UK and US*, OUP, 2011, 109-11.

[12] J. Wood, *Director's Duties and Creditor Protections in the Zone of Insolvency: A Comparison of the USA, Germany and Japan*, 26 Penn St. Int'l L. Rev. 139, 151; C.Mallon, S.Waisman, *The Law and Practice of Restructuring in the UK and US*, OUP, 2011, 109-11.

[13] A. Rokas, *Pre-Bankruptcy Procedure of Reorganisation of Companies*, Sakoulas, 2014, pp. 14-17.

[14] As per section 362 of the USBC.

reorganization scheme. This serves also as a form of pressure for the creditors to agree to the reorganization of the company. In addition, and in order to protect the fame of the company, as long as the procedure under Chapter 11 USBC takes place, the same corporate administration is maintained. It is also central, that any plan for reorganization is approved by court.[15]

When a company files for the Chapter 11 USBC bankruptcy protection, corporate directors and officers owe fiduciary duties to the corporation, creditors, and shareholders. The corporation also experiences a significant change in its governance and business relations, as creditors become active participants in all corporate affairs, negotiations, and reorganization processes. In the realm of the Chapter 11 USBC proceedings, directors and officers continue to operate the business and manage assets as a debtor in possession (DIP), where the DIP is a trustee in the position of a fiduciary with rights and powers of the Chapter 11 USBC trustee. As debtors in possession, the directors' and officers' duty of care are to maximize and protect the estate's assets, abstain from wasting assets, furnish information about the estate and its administration, and exercise reasonable diligence and care in formulating a reorganization plan. The directors' and officers' duty of loyalty in Chapter 11 USBC proceedings, is identical to the duty they owe when the corporation is solvent. The duty of loyalty requires directors and officers to refrain from self-dealing, to avoid conflicts of interest and the appearance of impropriety, and to treat all parties to the case fairly.[16]

III. The Position in Germany

Germany's system of corporate governance differs from the U.S. both structurally and substantively. Structurally, German companies are required to adopt a two-tier board of directors in an attempt to protect shareholder interests. Additionally, Germany's system of co-determination requires employee representation on the upper-tier supervisory board, making German boards much larger than boards of comparable companies in the USA. Substantively, Germany operates under the stakeholder model, where directors manage the firm on behalf of shareholders, employees, and the larger community. Also, German banks play a more central role in corporate governance than their counterparts in the USA.

a) Director Duties under Germany's Corporate Governance System

German law requires corporations to adopt a two-tier, hierarchical board structure. Shareholders and employees elect members of the supervisory board. The supervisory board appoints and oversees the management board. In turn, the management board conducts the affairs of the corporation.

A German cultural norm suggests that management should give each corporate constituent's interests equal weight in decision-making. However, in practice, management often aligns with banks and other powerful shareholders.

[15] A. Rokas, *Pre-Bankruptcy Procedure of Reorganisation of Companies*, Sakoulas, 2014, pp. 14-17.

[16] J. Wood, *Director's Duties and Creditor Protections in the Zone of Insolvency: A Comparison of the USA, Germany and Japan*, 26 Penn St. Int'l L. Rev. 139, 151; C.Mallon, S.Waisman, *The Law and Practice of Restructuring in the UK and US*, OUP, 2011, 109-11.

German law allows only the board to bring a lawsuit on behalf of the corporation. Additionally, lawsuits challenging actions of the management board or against directors individually may only be brought by the supervisory board. Thus, unlike the US system, shareholders of German corporation's typically do not bring derivative actions challenging director action. Moreover, the supervisory board faces disincentives to bring litigation against the management board since the corresponding allegations often question the supervisory board's performance.[17]

b) *The Parameters of the Zone of Insolvency in Germany*

The parameters of the zone of insolvency under German law are amorphous and difficult to define. Like the judicial decisions in the USA, legal rules in Germany attempt to delineate situations where a corporation is approaching insolvency prior to the initiation of insolvency proceedings. Accordingly, German law lists three distinct situations where a corporation is considered approaching insolvency. First, German law treats a company that experienced substantial annual losses as approaching insolvency. The threshold of losses under this test is equal to one-half the share of capital on the annual balance sheet. Secondly, a corporation may be approaching insolvency when it is unable to make payments when payments are due. And, finally, over-indebtedness is an indication that a corporation is approaching insolvency as well.

German law addresses the agency cost problems encountered in the zone of insolvency by providing creditors additional corporate governance protections when a company approaches insolvency. These corporate governance protections can be organized into two categories. First, legal rules impose specific duties on directors as a company approaches insolvency. Second, directors are personally liable to creditors for failure to discharge the duties created in the zone of insolvency.[18]

c) *Director Duties as Corporation Approaches Insolvency*

When each of the statutory conditions defining “approaching insolvency” are met, German law imposes specific duties on directors.

The Aktiengesetz, the German Stock Corporation Act, requires management to initiate insolvency proceedings without undue delay. Although undue delay is not defined, insolvency proceedings must be initiated within three weeks after the corporation becomes over-indebted or unable to make payments when due. This duty to initiate insolvency proceedings protects creditors in several ways. First, it prevents directors from gambling with corporate assets by undertaking risky investments when the company is nearing insolvency. Second, it provides notice to existing and potential creditors of the company's financial distress. Third, by initiating insolvency proceedings quickly, it preserves the priority of payment established by the insolvency regime, preventing payments to preferred creditors. Once a corporation experiences losses equal to half of the share of capital on the annual balance sheet, the management board must call a shareholders meeting. At the

[17] J. Wood, *Director’s Duties and Creditor Protections in the Zone of Insolvency: A Comparison of the USA, Germany and Japan*, 26 Penn St. Int'l L. Rev. 139, 154-155.
[18] J. Wood, *Director’s Duties and Creditor Protections in the Zone of Insolvency: A Comparison of the USA, Germany and Japan*, 26 Penn St. Int'l L. Rev. 139, 153-155.

meeting, management must provide the shareholders with notice of the corporation's financial distress. This duty to call a shareholders meeting provides protection to both shareholders and creditors by providing prompt notice of the company's financial distress. Although primarily aimed at notifying shareholders, creditors will benefit as well, since many banks are also shareholders.[19]

d) *Directors' Personal Liability to Creditors for Failure to Discharge these Duties*

In addition to imposing specific duties on directors, once a corporation enters the zone of insolvency, German law provides additional creditor protection through director liability. Directors can be found personally liable to creditors, for failure to discharge statutory duties and for failure to adhere to capital maintenance rules.

Creditors may pursue personal liability claims against directors only when the creditor cannot recover from the corporation itself. German law allows creditors to recover personally from directors who violate certain enumerated duties. Section 93(3) of the Aktiengesetz lists nine situations through which creditors may asset claims against directors. In financially distressed companies, creditors can pursue directors for, *inter alia*, repayment of contributions to shareholders, payment of interest or dividends to shareholders, distributing assets of the company, making payments once the company is over-indebted, and extending additional credit. However, the code specifies that directors are only liable to creditors under a gross negligence standard. In addition to the situations enumerated in section 93(3) of the Aktiengesetz, creditors may bring claims against directors for gross violations of the duty of care. Directors are subject to personal liability to creditors for failure to adhere to capital maintenance rules at any time. Although director liability, under this provision, is irrespective of whether the corporation is in the zone of insolvency, as a practical matter, creditors are not encouraged to bring a claim against a director under this provision unless the company is in financial distress. Directors face *per se* liability to creditors under this provision.[20]

e) *The Pre-Bankruptcy Scheme under German Law*

In Germany, the law offering the option to file for pre-bankruptcy reorganization was introduced on 01.03.2012.[21] The law offered a "shield procedure" ("Schutzschirmverfahren") which allows companies which are in a state of being close to stay of payments or over-debt to seek the suspension of any enforcement for up to three months, a period during which a reorganization plan needs be drafted and judicially approved. The procedure has as positive features the fact that the reorganization plan is secured and promoted as a procedure in itself, through practices such as the "debt for equity swap"; the fact that the debtor has the option to be the administrator of the assets under

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[19] J. Wood, *Director's Duties and Creditor Protections in the Zone of Insolvency: A Comparison of the USA, Germany and Japan*, 26 Penn St. Int'l L. Rev. 139, 156-157.

[20] J. Wood, *Director's Duties and Creditor Protections in the Zone of Insolvency: A Comparison of the USA, Germany and Japan*, 26 Penn St. Int'l L. Rev. 139, 156-159.

[21] "Gesetz zur weiteren Erleichterung der Sanierung von Unternehmen" (ESUG)), Bundesgesetzblatt, https://www.bundesgerichtshof.de/SharedDocs/Downloads/DE/Bibliothek/Gesetzesmaterialien/17_wp/Esug/bgbl.pdf;jsessionid=0C369FFE6C8EF1A80B3F1DF494C64359.2_cid368?__blob=publicationFile&v=1, <accessed 17.05.2019>

bankruptcy; and also the fact that the creditors can appoint a bankruptcy administrator of their choice to administer the process and advise in the best possible way for the reorganization of the company.[22]

IV. The Position in Greece

In Greece, despite an overwhelming legislative action both in the field of company and in insolvency law, and although the Greek jurisprudence has dealt extensively with various protection mechanisms towards the corporate creditors, there was none generalized theoretical reflection observed, such as those which occurred in other jurisdictions. However, this does not apply as far as the insolvency law legislator is concerned, for he explicitly established the liability regime of the directors of capital companies for either triggering the bankruptcy process or for the late filing of the application for a declaration of bankruptcy. The relevant provisions (articles 96-98, 101,109,123,170 of the Greek Insolvency Code, (GIC)) rests on bankruptcy law, however it is also closely associated with company law. The above suggest the need to reassess the effectiveness of Greek law regarding creditors protection as this is being promulgated via the two main pillars of corporate and insolvency law.

The protection of corporate creditors is sought primarily in the case of capital companies, where the principle of separation, the subsequent lack of accountability of partners for corporate obligations towards third parties, as well as against the company, and the lack of involvement of creditors in the management of the company, constitutes the latter third parties as a vulnerable group, bearing the business risk of the company without at the same time being involved in the control mechanism and in the attribution of company benefits.[23]

Unlike corporate law, insolvency law puts first the protection of creditors. Article 1 GIC proclaims as its primary purpose the collective satisfaction of the creditors of the debtor. Through the GIC and the provisions on the consolidation of business the purpose of the fullest satisfaction of creditors is sought to be served. The insolvency process is legally transcribed, so as to be effected in such a way so as to effectively meet the bankruptcy requirements, and preserve the categorized equality of creditors. The main mechanism of protection of creditors in insolvency law is that of the dissolving of the company. With regard to the legal entities, the protection of creditors is even greater, since the insolvent entity is being dissolved as per article 96 GIC and accordingly ceases to be operative and obtains the aim to be liquidated. The protection of creditors is being complemented by the introduction of regimes of civil or criminal liability, which apply to shareholders or directors of capital companies (articles 98, 171, 172, 176 GIC). A prerequisite which should exist, so that the protection mechanisms of insolvency law be applied to the creditors for their protection, is the declaration of the company as insolvent, an act which is being deterred from happening as per company law provisions. Hence, and in contrast with the company law provisions which offer an *ex ante* protection for the

[22] A. Rokas, *Pre-Bankruptcy Procedure of Reorganisation of Companies*, Sakoulas, 2014, p. 40.
[23] R. Giovannopoulos, *Creditors Protection in Company and Insolvency Law. Comparative Remarks, 18th Greek Commercial Lawyers*, Association Conference, Kastoria 2008; U. Haas, *Reform des gesellschaftsrechtlichen Gläubigerschutzes*, (Gutachten E zum 66. Deutschen Juristentag), (2006), E 15.

creditors, insolvency law provides *a posteriori* (*ex post*) protection to corporate creditors. The interaction of company and insolvency law, as far as creditors' protection is concerned, is obvious, as already demonstrated. The Greek legislator, via the enactment of article 98 GIC and having already adopted foreign standards, included, for the first time in the bankruptcy legislation, the concept of the actual external accountability of the company directors, for the benefit and protection of corporate creditors, both in the case of dilatory bankruptcy and also in the case of the actual occurrence of bankruptcy. In terms of article 98 GIC, there are also particular harmonization issues with regards to the external responsibility of company directors towards corporate creditors before the actual declaration of bankruptcy, since the actual liability regime as per article 98 GIC is activated only after the company has been declared as bankrupt.[24]

a) <u>*The Regime for Creditor Protection: The First Phase of the Reform*</u>

In 2015, Greece introduced Law 4336/2015[25] so as to ratify the Financial Assistance Facility Agreement which had been effected with the European Stability Mechanism (ESM), which included, *inter alia*, amendments to the restructuring and insolvency law. These amendments were to a large extent in line with the "Restructuring Recommendation" (RR) of the European Commission, which was issued in 2014 and which was pushing towards harmonization,[26] with respect to the Member States' restructuring regimes. The most remarkable amendments thereof, were the following: a) pursuant to Article 31 par. 1 and 2 GIC, as amended, the initiation of a bankruptcy proceeding may no longer be seen as a reason to terminate an ongoing contract by virtue of an *ipso facto* contractual clause. A special treatment is introduced for ongoing financial contracts, contemplating the provision of banking, security and investment services, which are excluded from the above rule; and, therefore, can be automatically terminated or amended, due to the bankruptcy of a debtor, to the extent this has been agreed upon and provided by virtue of a relevant clause in force, prior to the declaration of its bankruptcy; b) articles 93 et seq. GIC, as amended, provide for the shortening of the regular bankruptcy proceedings making them more efficient by setting stricter timeframes for completion of various stages thereof. In particular, creditors have only one month from the declaration of bankruptcy (reduced from three months previously) to announce their claims, while the bankruptcy administrator, who is called "syndic", must verify them as a general rule within a month (reduced from three months previously) with the option to extend the timeframe up to three months. On the other hand, a new deadline of ten days from the judicial verification of the claims is set for the filing of objections before the bankruptcy court[27]; c) with regards to the rehabilitation procedure of Article 99 et seq. GIC, new criteria are being set regarding the opening of the proceedings, hence, rehabilitation proceedings can be initiated, when actual inability of the debtor to meet its obligations, as they fall due, is yet

[24] R. Giovannopoulos, *Creditors Protection in Company and Insolvency Law. Comparative Remarks, 18th Greek Commercial Lawyers*, Association Conference, Kastoria 2008.
[25] Law 4336/2015 (FEK A 94/14-08-15).
[26] C (2014) 1500 final, Brussels 12.3.2014.
[27] S. Frastanlis, *Recent Reform of Greek Restructuring and Insolvency Law*, International Corporate Rescue, (2016), Volume 13, Issue 2, 124-127, 124.

not present, but there is a likelihood of the debtor become insolvent and the competent court considers that its insolvency could be avoided through the recovery procedure.[28] The amendment is in line with the RR of the European Commission, which aims at giving financially distressed companies the opportunity to enter into a restructuring at an early stage.[29] Furthermore, the overall duration for negotiating and concluding a rehabilitation agreement has been extended to a more realistic period of four months, with the possibility of extending it further up to twelve months, provided that certain conditions are met. The previously valid provision of Article 100 par. 5 GIC regarding the obligation to pay a fee up to EUR 7,000 as an amount to cover various procedural costs, i.e. costs of professionals involved in the proceeding, has been abolished.[30] Pursuant to Article 103 par. 1a GIC, a stay of individual creditor enforcement action may be automatically granted by the bankruptcy court, under the condition that creditors representing at least 30% of the total value of the outstanding claims against the debtor, including 20% of the secured claims, proceed to a formal statement to the bankruptcy court, that they participate in the negotiations for the conclusion of a rehabilitation agreement. A renewal could be available only on the debtor providing evidence of progress in the negotiations and subject to a maximum total duration of twelve months. An automatic stay, suspending the right of the creditors to enforce a claim against the debtor can be granted in case an agreement has already been reached with the requested majority of the creditors and has been brought to the bankruptcy court solely for ratification ("pre-packed agreement").[31]

b) *Changes in the Greek Restructuring Law*

Following the RR of the European Commission issued in 2014[32], in 2016 Greece introduced Law 4446/2016,[33] in an effort to have in place key principles on all types of insolvency proceedings, in order to improve their quality and to efficiently tackle the accumulation of non-performing loans of ailing debtors.[34]

Pursuant to Article 99 par. 1 of the GIC as amended, the initiation of rehabilitation proceedings to negotiate an agreement with creditors following a formal court order was no longer an option and debtors need to commence restructuring negotiations at an early stage and without obtaining a relevant court order, with a view to reaching an out-of-court

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[28] S. Frastanlis, *Recent Reform of Greek Restructuring and Insolvency Law*, International Corporate Rescue, (2016), Volume 13, Issue 2, 124-127, 125.

[29] K. van Zwieten, *Restructuring law: recommendations from the European Commission*, (2014) EBRD, Law in transition online, pp. 2 et seq.; S. Frastanlis, *Recent Reform of Greek Restructuring and Insolvency Law*, International Corporate Rescue, (2016), Volume 13, Issue 2, 124-127, 125.

[30] S. Frastanlis, *Recent Reform of Greek Restructuring and Insolvency Law*, International Corporate Rescue, (2016), Volume 13, Issue 2, 124-127, 126.

[31] H. Eidenmüller/K. van Zwieten, *Restructuring the European Business Enterprise: The EU Commission Recommendation on a New Approach to Business Failure and Insolvency*, (September 2015) Working Paper No. 301/2015, pp. 13 et seq; S. Frastanlis, *Recent Reform of Greek Restructuring and Insolvency Law*, International Corporate Rescue, (2016), Volume 13, Issue 2, 124-127, 125, 127.

[32] C (2014) 1500 final, Brussels 12.3.2014.

[33] Law 4446/2016 (Government Gazette Issue n. 240/Bulletin A'/22.12.2016.

[34] S. Frastanlis, *Pushing Towards Efficiency: New Changes in Greek Restructuring and Insolvency Law*, International Corporate Rescue, (2017), Volume 14, Issue 4, 281-284, 281.

agreement with the requested majority of its creditors.[35] Pursuant to Article 106a GIC, a stay suspending the right of the creditors to enforce claims against the debtor, is to be granted in the out-of-court negotiation period, i.e. prior to the submission of the agreement to the court for ratification, on the condition that creditors, representing at least 20% of the total value of the outstanding claims, will issue a written statement that they participate in the negotiations for the conclusion of a rehabilitation agreement. Pursuant to Article 100 par. 1 GIC, a rehabilitation agreement may be drafted and submitted to the Court for ratification only by the creditors, without any participation of the debtor, provided that the latter has ceased payments and the required majority of 60% of the creditors' claims, 40% of which should be secured, has been met.[36]

c) Changes in the Greek Insolvency Law

With regards to the opening of insolvency proceedings, as per article 3 GIC, except where the debtor has ceased payments or a cessation of payments is imminent, insolvency proceedings can be initiated when there is a likelihood of the debtor becoming insolvent and the latter submits to the Court, along with the petition for bankruptcy, a plan to re-organize its business as per Article 107 seq. GIC.[37]

To improve the efficiency of the insolvency proceedings and the restructuring option of the reorganization plan included therein (Article 107 seq. GIC), the legislator proceeded to various changes with a view to a more flexible and quick procedure. In particular, the involvement of the Court in the process was confined to the extent necessary and proportionate, i.e. Article 114 GIC providing for the Court's competence to pre-examine a submitted reorganization plan has been abolished as well as the 'creditors' committee', an optional supervisory progress board. Finally, the legislator provided for the shortening of the insolvency proceedings by making the timeframes for completion of various stages thereof even stricter.[38]

V. The Position in Croatia

Croatia undertook the German "Insolvenzordnung" as the role model for the

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[35] Proposal for a Directive of the European Parliament and of the Council on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures and amending Directive 2012/30/EU, COM(2016) 723 final, 22.11.2016, p. 28 (18); H. Eidenmüller/K. van Zwieten, *Restructuring the European Business Enterprise: The EU Commission Recommendation on a New Approach to Business Failure and Insolvency*, (September 2015) Working Paper No. 301/2015, p. 13.

[36] S. Frastanlis, *Pushing Towards Efficiency: New Changes in Greek Restructuring and Insolvency Law*, International Corporate Rescue, (2017), Volume 14, Issue 4, 281-284, 281-283.

[37] H. Eidenmüller, *Reformperspektiven im Restrukturierungsrecht*, 31 Zeitschrift für Wirtschaftsrecht (2010), 649, 650; S. Frastanlis, *Pushing Towards Efficiency: New Changes in Greek Restructuring and Insolvency Law*, International Corporate Rescue, (2017), Volume 14, Issue 4, 281-284, 282-283.

[38] Proposal for a Directive of the European Parliament and of the Council on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures and amending Directive 2012/30/EU, COM(2016) 723 final, 22.11.2016, p. 25 (4); S. Frastanlis, *Pushing Towards Efficiency: New Changes in Greek Restructuring and Insolvency Law*, International Corporate Rescue, (2017), Volume 14, Issue 4, 281-284, 284.

reformation of its insolvency law in the late nineties,[39] as it was the case with so many other Croatian laws that were inspired by German and Austrian legal acts. This custom can be even better understood, when taking into account the fact that Croatia was once a part of Austro-Hungarian Monarchy, and therefore its legal tradition is historically linked to the ones of its western neighbors. When mentioning neighbors, the Slovenian model of Pre-Bankruptcy Procedure that aimed for the reorganization of the indebted company inspired the Croatian legislator to introduce a similar model in Croatia, enacted by the Law on financial transactions and pre-bankruptcy settlement in 2012 (ZFPPN 2012).[40]

Although the intentions of the legislator were good, in practice this law gained a lot of negative publicity that culminated in statements which were claiming that it fostered corruption and misused company losses for the sake of certain individuals, who in that manner obtained a legal mean as to how to strip companies from their assets. The reason for this negative criticism was mainly the fact that according to the legal provisions of ZFPPN 2012, the whole procedure was conducted before the Financial Agency/FINA *[Financijska agencija]*,[41] a state entity that serves as a payment agent and employs civil servants and not judges that are trained for this kind of procedures. However, this solution was enhanced by the rule that the pre-bankruptcy proceeding that culminated in the signing of the pre-bankruptcy settlement was to be finalized at the Commercial court, whereby a final stage of the procedure, namely the signing of the pre-bankruptcy settlement would take place and ensure the legal effects of the court order for the pre-bankruptcy settlement.

Undoubtedly, the aims of the legislator might have been well intended, as he probably wanted to save the courts from the overload of insolvency cases and speed up the process of corporate rescue from bankruptcy.[42] However, the reality was that in practice the very complicated issues concerning debts and recovery plans were solved by the civil servants of the the Financial Agency, who were not specialized personnel as they had no relevant education or experience for this kind of cases. Furthermore, the existing legal framework that posed most of the responsibility on the debtor when determining the list of creditors and debts, brought the negative effect that debtors would conspire with related parties or significant creditors and all of the sudden new creditors with huge debts would appear and overtake the guidance of the pre-bankruptcy procedure, to the damage of other creditors and/or the indebted company as well.[43] All of this negative trend has culminated in the case of one famous Croatian company that underwent this procedure and was about to cease the pre-bankruptcy settlement before the Commercial court in Zagreb. The judge that was appointed to this case however refused to sign the decision that would grant the legal effects of the court order to this document, claiming that the whole procedure and the

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[39] Ž. Bartulović; D. Bodul; A. Vuković, *Legal history and comparative review of the development of bankruptcy proceeding [Pravnopovijesni i poredbenopravni prikaz razvoja stečajnog postupka],* Zbornik Pravnog fakulteta Sveučilišta u Rijeci, Vol. 34, No. 2, 2013, p. 934.

[40] D. Bodul; A. Vuković, *(Another) Bankruptcy Legislation reform - functionalization of bankruptcy legal protection or placebo effect? [(Još jedna) reforma stečajnog zakonodavstva – funkcionalizacija stečajno pravne zaštite ili placebo efekt?]*, Zbornik Pravnog fakulteta Sveučilišta u Rijeci, Vol. 36, No. 1, 2015, p. 186-187.

[41] Official site available at https://www.fina.hr, <accessed July 7, 2019>.

[42] M. Dika, *The procedure of Concluding the Pre-Bankruptcy Settlement [Postupak sklapanja predstečajne nagodbe]*, available at the site of Higher Commercial Court of Croatia at https://www.vts.hr, p.1. <accessed July 7, 2019>.

[43] J. Garašić, Most important novelties in Bankruptcy Act of 2015 *[Najznačajnije novine Stečajnog zakona iz 2015. godine]*, Zbornik Pravnog fakulteta Sveučilišta u Rijeci, Vol. 38, No. 1, 2017, p. 142.

legal provisions that it was based on, were unconstitutional. He even went that far to file a constitutional claim against the ZFPPN 2012, but his claim was dismissed and the aforementioned case was simply appointed to another judge. However, this particular judge was not disheartened from this course of action and continued to adjudicate in a similar way when dealing with other legal cases, even when they did not enter the sphere of his legal expertise.[44]

Although the afore mentioned constitutional claim against ZFPPN 2012 was dismissed, it led to the law being significantly changed via a big reform of the Croatian Insolvency Act in 2015 (InsA 2015). This reform transposed the whole pre-bankruptcy procedure from ZFPPN 2012 to InsA 2015 which continued to serve as a unique source of the Croatian insolvency law for corporations. Purely formally, the reform and the changes it brought are to be seen in a positive light, because it helped assemble and codify all relevant provisions - which up until then were scattered in several pieces of legislation – in one law and in this way enhanced legal certainty and made the procedure practically speaking easier, for all parties concerned.

a) *The Pre-Bankruptcy Phase*

Whereas the bankruptcy phase usually ends with the liquidation of the company, the aim of the pre-bankruptcy procedure is to save the company from collapsing via the reorganization and financial restructuring. However, and in order to do this successfully, it is very important to recognize the existence of this phase early on and start the necessary recovery mechanisms in time.[45] Therefore, in Croatia, many companies started to foster their controlling departments, that can use certain methods, in order to predict and avoid financial difficulties, such as budget of income, comparison with competition, SWOT analyses etc.[46]

The pre-bankruptcy procedure in Croatia is to be initiated when a corporation is unable to make payments, at the time point that such payments are due. The procedure is no longer conducted by FINA, but as per the InsA 2015, it is to be administered by the competent commercial court. The role of this court is to determine if the company is unable to meet its obligations in due course, and the whole court procedure is led by a single judge. This procedure is characterized through several basic legal principles that follow different legal provisions throughout the whole procedure. The first of these principles is the voluntary nature of the pre-bankruptcy settlement, which is concluded only when the debtor and sufficient number of creditors agree on it. The principle of equal treatment ensures that the debtor treats the creditors of the same sort in the same way and, hence, it is prohibited for the debtor to undertake any sort of actions that could lead to the unequal treatment and classification of the same sort of creditors. The general principle of *bona fidae* is stressed out in this procedure as well, since it is prohibited both for the creditors and for the debtor to undertake actions that could cause financial distress and further

[44] More details on this matter can be found at https://www.index.hr/vijesti/clanak/tko-je-mislav-kolakusic-najvece-iznenadjenje-ovih-izbora/2088504.aspx. <accessed July 7, 2019>.
[45] A. Vuković, How timely initiation of bankruptcy proceedings can contribute to the improvement of conditions criteria of efficiency? [Kako pravovremeno pokretanje stečajnog postupka može doprinijeti poboljšanju njegove efikasnosti?], Zbornik Ekonomskog fakulteta u Zagrebu, Vol. 14, No. 2, 2016, p. 144.
[46] E. Priskić; L. Bačić, Bankruptcy as a Function of Company Revitalisation [Stečaj u funkciji revitalizacije trgovačkog društva], Učenje za poduzetništvo, Vol. 2, No. 2, 2012, p. 357.

damage. Finally, the principle of access to information, ensures that the debtor is required to enable other stakeholders to get any relevant information and documents that are important with regards to its financial restructuring.[47]

b) The Bankruptcy Phase

Whereas the procedure conducted in the pre-bankruptcy phase aims for the recovery of the financially troubled company, in the bankruptcy phase this recovery seems highly unlikely and the goals of the procedure are to wind up the remaining business of the company, cash in as much of the property as possible, and pay out the outstanding debts without damaging the interestes of the involved stakeholders, if possible.

Under Croatian law, similar to the German law, one can initiate a bankruptcy procedure when either of the follwoing two possible reasons are met, i.e. over indebtedness or inability to make payments when such payments are due. The group of people entitled to initiate this procedure is wide and it includes the debtor himself, its managers or executive directors and the members of the supervisory board, in case tthe managers are not in place to initiate the procedure, as well as the owners who can initiate the procedure in case the company has no longer appointed directors. Beside the creditors, the FINA is also entitled to start a bankruptcy procedure. This role of the FINA is related to its role of the payment agent in charge of the withdrawal of monetary means in the execution procedure. When there is no money on the account of the debtor and an execution title stays unpaid for more than 120 days, the FINA has to start a bankruptcy procedure against the debtor. In this way the FINA, even if not leading the procedure itself, continues to play a significant role in the whole process. Furthermore, the sale of real estate of the debtor is also conducted by the FINA where she serves to provide a technical support to the court.[48]

Besides the debtor, the judge and the creditors who form a special committee which represents the bodies of the bankruptcy proceedings, an important role is that of the bankruptcy commissioner. The bankruptcy commissioner represents a body often described as the most important one in the bankruptcy proceedings,[49] for it could be said that the bankruptcy commissioner represents some kind of "prosecutor" and "guarantor" for al sides concerned as, on the one hand, he is responsible to present to the court the state of affairs of the company, whilst on the other hand he is responsible to overtake charge of all of the duties of the management and in this way he eventually becomes an official representative of the company during its bankruptcy phase. Recognizing the importance of this function, the Croatian legislator has foreseen certain conditions that one must meet, in order to be added to the official list of the bankruptcy commissioners that is lead by every commercial court separately. These conditions include certain level of education, experience and the successful sitting of an official exam administrated by the Ministry of

[47] M. Dika, *The procedure of Concluding the Pre-Bankruptcy Settlement [Postupak sklapanja predstečajne nagodbe]*, available at the site of Higher Commercial Court of Croatia at https://www.vts.hr, p. 7-8 <accessed July 7, 2019>.
[48] D. Bodul, Apology of the new Croatian Insolvency Law *[Apologija novom hrvatskom insolvencijskom pravu]*, FIP - Financije i pravo, Vol. 4, No. 1, 2016, p. 234.
[49] D. Bodul, Apology of the new Croatian Insolvency Law *[Apologija novom hrvatskom insolvencijskom pravu]*, FIP - Financije i pravo, Vol. 4, No. 1, 2016, p. 238-239.

Justice.[50] The person of the bankruptcy commissioner is then chosen by the each time adjudicating judge through the method of random selection from the afore mentioned list, but creditors have a right to propose a specific person for this duty, should they wish to do so. Due to the high standards that bankruptcy commissioners need to meet in order to be able to step into the procedure, it is no surprise that they have a right to get an adequate remuneration for their work. However, it is exactly this remuneration together with other costs of the bankruptcy proceedings raises doubts about the efficiency of the bankruptcy proceedings. According to some defeating statistics, creditors manage to solve only 10,4% of their claim in the bankruptcy proceedings whereas the average costs of the proceedings reach 15% of the claim value. In addition, there have been cases when the value of the company was assessed to several million of Croatian Kuna and whereby the creditors did not any remuneration at all from these assets whereas the commissioner regularly received his remuneration and was also entitled to file for extra costs with no further specifications thereof.[51]

The fiduciary duties of the commissioner and of other stakeholders in this process, are in detail contained in the Croatian Criminal Act. This act has a special chapter for economic crimes and lists several different crimes that can be attributed to parties in cases of misuse of the corporate bankruptcy proceedings. Amidst the list of crimes, one can find crimes such as the deliberate causing of bankruptcy, the discrimination of creditors and the corruption during the bankruptcy proceedings.[52] For some of these crimes, the law foresees as a punishment, an imprisonment of up to 10 years. Interestingly and usefully at the same time, for some cases the law foresees the possibility of exclusion from punishment, in case that all of the creditors manage to settle all of their claims before the verdict is reached.

Furthermore, according to the article 239 of Croatian Companies Act, one can not become a company director if one has been sentenced for one of the above mentioned crimes, and this applies to a period of 5 years from the validity of the verdict. This sets up a good example on how different legal areas can, each with its own mechanisms, beautifully interact and ensure the right application of certain legal provisions.

V. Minimization of Creditor and Shareholder Conflicts of Interest

In the zone of insolvency there are four specific conflicts of interest between shareholders and creditors. These specific conflicts of interest are divergent risk preferences, shareholder incentives to siphon assets out of the firm, liquidation preferences, and shareholders' incentives for underinvestment. The USA legal, addresses three of these four conflicts of interest: a) first, by allowing managers to consider the interests of both shareholders and creditors, the impact of divergent risk preferences between these groups is mitigated; this further allows management to use its expertise to pursue the course of

[50] For more detailed specification of these conditions, see article 77-82 of Croatian Insolvency Act (Official Gazette 71/15, 104/17).

[51] D. Sajter, Bankruptcy: Framework for fraud, or for creditor settlements and trust rehabilitation? *[Stečaj: Okvir za malverzacije ili za namirenje vjerovnika i rehabilitaciju povjerenja?]*, Ekonomski pregled, Vol. 65, No. 4, 2014, p. 308, beside the case mentioned in this work, the author lists many other good examples of costs manipulation.

[52] For detailed description of these crimes and foreseen punishments, see articles 249-251 of Croatian Criminal Act (Official Gazette 125/11, 144/12, 56/15, 61/15, 101/17, 118/18).

action it feels is best for the corporation as an economic entity, and, moreover, the US strategy protects managers who enter transactions for the benefit of the firm in good faith; b) second, by granting creditors a standing so as to sue directors for breaching the duty of loyalty once the company is insolvent, and in this way by giving creditors the ability to protect themselves against shareholders siphoning assets out of the firm. By removing a manager's incentive to undertake this socially undesirable action, this strategy minimizes the conflict of interest; c) third, by allowing the management to pursue the interests of creditors in the zone of insolvency, hence mitigating the impact of shareholder incentives for underinvestment. Managers will be more likely to undertake transactions that will only benefit creditors since they will not lose the protection of the business judgment rule.

It is notable that the legal response in the USA does not adequately address the divergent liquidation preferences between creditors and shareholders. This leads to costly valuation litigation as creditors and shareholders squabble over whether a company should be liquidated or reorganized.

The German legal strategy addresses two of these conflicts of interest by preventing management from undertaking risky transactions or siphoning out assets to shareholders. By granting creditors standing to sue directors for grossly negligent business decisions in the zone of insolvency, managers will be unlikely to undertake excessively risky transactions. Likewise, the risk that managers will siphon corporate assets out to shareholders is eliminated by barring such transactions in the zone of insolvency. However, Germany's legal response, which provides little management flexibility, does not minimize the conflicts of interest created by divergent liquidation preferences and shareholder incentives for underinvestment. By forcing managers to initiate insolvency proceedings, shareholders will have any little say in whether the company liquidates or reorganizes. Likewise, by barring most transactions, once a company enters the zone of insolvency, managers will be unlikely to undertake investments whose benefits only flow to creditors.[53]

In Greece the position of the law and the basic reflection of the legislator, as far as shareholders and creditors are concerned, is geared towards a mechanism that serves the requirement of legal capital and its preservation. The requirement exists, on the one hand, in company law for the generation of legal capital and its preservation; however, this having been said, there also exists the legal requirement, under insolvency law, to preserve the legal capital and not redistribute it, until the complete satisfaction of creditors in terms of the liquidation process. Directors are expected by law to assert careful management of the corporate assets, otherwise they carry internal liability for detrimental acts, mismanagement or excessive risk taking, in relation to the corporate assets, and are liable towards corporate creditors.[54] The position can be criticized as similar to the one under German law. On the one hand the extremely high leveled net of protection of shareholders which also extends to creditors is a positive step towards the better enhancement of creditor protection, especially in case of insolvency. Moreover, corporate creditors are empowered with "weapons" of recourse towards corporate directors should they fall liable internally for jeopardizing or misusing the corporate assets. However, this rigid regime can be seen

[53] J. Wood, *Director's Duties and Creditor Protections in the Zone of Insolvency: A Comparison of the USA, Germany and Japan*, 26 Penn St. Int'l L. Rev. 139, 165.

[54] R. Giovannopoulos, *Creditors Protection in Company and Insolvency Law. Comparative Remarks, 18th Greek Commercial Lawyers*, Association Conference, Kastoria 2008.

as a halt towards the potential for directors to undertake excessively risky transactions, such as the undertaking of investments whose benefits will subsequently also positively affect the company creditors.[55]

Under Croatian law, the wide scope of crimes related to corporate bankruptcy which are listed in the Croatian Criminal Act result in establishing the impression that the Croatian legislator tried, through their enactment, to tackle all the above listed conflicts of interests, in order to cover the possibility that they may not have been well managed by the extensive and detailed provisions of InsA 2015 or of the Croatian Company Act. However, in order to judge the effectiveness of this solution, one would need to conduct a research on the application of these criminal provisions in practice. It is widely acknowledged that it is too difficult to prove an intention of fraud in corporate crimes, and therefore it is rather certain that the statistics would not compliment the intentions of the legislator with regards to this matter.

VI. Determining the Best Corporation Strategies

The policy of maximizing firm value is superior to maximizing creditor or shareholder value. Maximizing firm value theoretically maximizes value for all stakeholders, including creditors and shareholders. Moreover, it provides management more flexibility to determine the best strategy for the corporation. Thus, management can determine whether the best approach in a struggling company is a workout with creditors, reorganization, or liquidation. A strategy that maximizes the company’s value attempts to promote the welfare of all stakeholders. Because the company value can be maximized through either liquidation or operation of the company as a going concern, this strategy provides the flexibility to choose the best outcome. In contrast, a strategy that requires the maximization of the company value to either shareholders or creditors at the expense of the other could lead to a socially undesirable outcome. Thus, strategies that allow for the company’s maximization are preferable to strategies that, as a policy matter, place one stakeholder's interests above the other's.

The US strategy gives directors the discretion to determine the best manner in which to operate the company in the zone of insolvency. Directors will be insulated from personal liability if they discharge their fiduciary duties in good faith with the belief that the action taken is in the best interests of any stakeholder. Accordingly, this gives directors, who have the best information about the company's financial position, the flexibility to pursue the course of action most likely to maximize the company’s value.

In contrast to the US strategy, the German strategy requires directors to initiate insolvency proceedings and limits directors' ability to enter transactions. This strategy maximizes firm value for creditors at the expense of shareholders and other stakeholders. Initiating insolvency proceedings immediately protects creditors by preventing the company from worsening its financial position. Moreover, director liability to creditors for undertaking certain transactions reduces directors' willingness to undertake transactions that could benefit all stakeholders. Like Germany's overall system of

[55] R. Giovannopoulos, *Creditors Protection in Company and Insolvency Law. Comparative Remarks, 18th Greek Commercial Lawyers*, Association Conference, Kastoria 2008.

corporate governance, this legal strategy is much more risk adverse than the US strategy.[56]

VII. Creditor Protection Through Mandatory Disclosure

Creditor protection through mandatory disclosure has long been a highly debated issue among corporate lawyers. It is almost self-evident that those who lend money or advance credit can benefit from having reliable financial information pertaining to the corporation with whom they deal. This is true for any type of creditor, be it a bank, an institutional investor, a commercial creditor in supply industries, or the proverbial small tradesman rendering services to the corporation. It is, therefore, perfectly plausible that corporations provide their various creditors to a very large extent with information regarding their financial status. In addition, many jurisdictions require corporations to publicly disclose certain basic information before starting business or borrowing funds. Disclosure stands right in the center of the debate over the best and most efficient ways to organize company activities vis-à-vis shareholders, creditors and other market participants. Regulators are in the process of addressing whether their domestic disclosure rules are rigorous enough in the light of the problems and implications thrown up by corporate collapses and the risks associated with inadequate disclosure. Investor confidence in the capital market, is an overriding aim of disclosure and investor protection, as well as market protection, are subsidiary aims of mandating disclosure. Mandating disclosure reduces the cost of capital, benefits market price accuracy and hence enforces market efficiency. At the center of the law and economics debate, over disclosure as a regulatory tool, stands the question whether and to what extent the mere dissemination of issuer information should be mandatory and managed by public rules or left to market forces and the incentives given to companies and other suppliers of information to provide adequate disclosure.[57]

Mandatory disclosure in the context of the creditors protection is not solely a responsibility of the corporate debtor and is not only related to the business of the corporation. The Croatian example of unjustified costs in the bankruptcy proceedings shows, in the best way, how important it is to have transparency abided with for the benefit of all the participants, especially bankruptcy commissioners, throughout the whole procedure.[58]

VIII. Conclusions

One of the major issues discussed between the common law and continental law jurisdictions is the legitimacy of legal capital requirements as an *ex ante* means to protect

[56] J. Wood, *Director's Duties and Creditor Protections in the Zone of Insolvency: A Comparison of the USA, Germany and Japan*, 26 Penn St. Int'l L. Rev. 139, 167.
[57] H. Merkt, *Creditor Protection Through Mandatory Disclosure*, in H. Eidenmuller, W.Schon, (Eds.) *The Law and Economics of Creditor Protection, A Transatlantic Perspective,* 2008, TMC Asser Press, The Hague, 93-98.
[58] D. Sajter, Bankruptcy: Framework for fraud, or for creditor settlements and trust rehabilitation? *[Stečaj: Okvir za malverzacije ili za namirenje vjerovnika i rehabilitaciju povjerenja?]*, Ekonomski pregled, Vol. 65, No. 4, 2014, p. 312.

creditors. In contrast, the common law world makes use of an *ex post* approach by assigning duties to directors to respect creditors interests in the vicinity of insolvency.

There are mixed views about the efficiency of legal intervention to protect creditors of corporate enterprises. On the one hand, it seems that little legal intervention is needed to protect "adjusting creditors," who can assess credit risk, contract for their own protection, and demand compensation for any residual risk that they choose to bear, however the question arises whether the law sufficiently protects "non-adjusting creditors", especially tort creditors who cannot demand compensation *ex ante* for the credit risks that they bear involuntarily.[59] It is not at all obvious that any *ex ante* protections are necessary or advisable, except for the baseline legal protection against fraud. However, to the extent that the law does prescribe *ex ante* terms in agreements between adjusting creditors and corporations, the assumption of a savvy contractor, strongly suggests that, these terms should be cast as default provisions that the parties can waive, and, secondly, that they should be designed to reduce transaction costs between corporate debtors and creditors, or overcome collective action problems that prevent dispersed creditors from reaching mutually beneficial agreements.

Modern commentators urge for a wider application of *ex post* protection of creditors through responsibility provisions. *Ex post*, i.e. after a contract has been executed, there is arguably more room for legal intervention on behalf of the voluntary creditors of corporate debtors to offset the risk of midstream opportunism. All of the *ex post* creditor remedies, let us conclude that both shareholders and managers have a strong incentive to remove value from creditors, in the vicinity of insolvency. Moreover, shareholders and managers are motivated to make poor decisions and undertake inefficient projects in these circumstances, precisely because they no longer bear the downside costs. As creditors' contractual remedies no longer work, when shareholders are in their "final period", they have nothing left to lose by shifting value from corporate creditors because there is nothing left in the corporate treasury. In this case, civil damages are no longer an effective incentive for the debtor. However, civil damages against third-party gatekeepers with external pools of assets remain possible, whether these parties are directors,[60] shareholders,[61] or creditors and other third parties.[62]

Convergence between the company law systems of the US and Europe still seems to have some way to go, in the realm of creditors' protection, although the debt financiers' reliance on contractual covenants means that the gap is narrower than the one that might be suggested by a glance at any company law statute book. Yet, even if the legal regimes are still some way apart, this is not necessarily negative. In other words, merely the fact that the approach in one region is different to that adopted elsewhere, does not constitute a sufficient reason to change it. Diversity matters, if it results in the delivery of different levels of creditors' protection and not if it may result in being a source of complexity. Diversity also matters, if it means that certain economically worthwhile transactions are possible in some jurisdictions or regions, but not in others because of legal impediments or

[59] See generally Henry Hansmann, Reinier Kraakman, and Richard Squire, 'Law and the Rise of the Firm', 119 Harv. L. Rev. 1333 (2006); See R. Kraakman, *Concluding Remarks on Creditor Protection*, EBOR 7, (2007), 465-471, 465

[60] Such as e.g. in the case of wrongful trading.

[61] Such as e.g. via the measure of equitable subordination and veil piercing.

[62] Such as e.g. in the case of fraudulent conveyance law; See R. Kraakman, *Concluding Remarks on Creditor Protection*, EBOR 7, (2007), 465-471, 469-471.

if such transactions are more costly to execute, because navigating the legal maze is a more complex task. Hence, where the general economic well-being of society is losing out because of differences in regulatory strategies, policy-makers need to pay attention.[63]

[63] E. Ferran, *The Place for Creditor Protection on the Agenda for Harmonisation of Company Law in the European Union*, 3 ECFR 178 2006, 214-215.